Banking Services Task Force Working Paper 1

Department of the Treasury
Review of the Commonwealth's Usage of Banking Services
Briefing to the Banking Services Operational Review Team
October 12, 2010

Goal: The goal of the Operational Review Task Force is to find cost savings and to assure the taxpayers that the Commonwealth is doing everything in its power to reduce its costs. The Banking Services Operational Review Team is charged with four goals:

- Determine the total spend at the state level.
- Suggest a set of "best practices" to employ to reduce costs.
- Recommend a reasonable level of consumption and/or price that could be achieved if the best practices recommended are implemented.
- Recommend a reasonable level of cost savings that could be achieved.

Scope of Analysis: The scope of Treasury's analysis is to look at cash flows and related activities through the state's banking network. The analysis included a review of procurement, bank products, payment and receipt mechanisms, and the maximization of investment monies as outlined below.

Total Spend: The total cost of banking services from all banks in FY10 is $3,775,179. This cost is paid for in both compensating balances and direct dollar payments. Attached is a breakdown of bank service fees from FY 2006 to FY 2010. (**See Exhibit A**) Changes in bank service costs are driven by changes in volume, price increases/decreases, and changes in the way in which services are used. For instance, the cost of electronic payments at $.08 per payment is one half the bank charge for processing a paper checks at $.15 per check. Therefore, as less expensive cash management products are developed and made available for agency use, the cost of banking is reduced. In a number of instances, the efficient use of a banking service can produce a decrease in agency operating expenses in addition to a reduction in banking costs. For instance, this shift from paper checks to electronic payments has an even larger impact on Treasury as the direct cost to Treasury to produce and mail a paper check is $.73 per check and reducing the number of checks processed reduces Treasury's operating costs.

Best Practices: The following is a listing of best practices used to manage cash flows and banking costs:

- <u>Payment of Bank Services Costs:</u> The cost of bank services is paid through a combination of direct payments and compensating balances. Banks reduce the fees charged to state bank accounts with an earnings allowance rate to somewhat offset bank fees charged based on balances held in these accounts (compensating balances). The earnings allowance rate is a percentage of the compensating balances held in the bank account. The current earnings allowance rate is from .4% to .75% of balances held in the bank. A best practice followed by Treasury is to monitor the earnings allowance given for balances held in the bank versus the rate that can be earned by the investment of those balances. The short-term portfolio interest rate on investments for FY 2009 was 2.80% and for FY 2010 was .92%. If the investment rate is higher than the earnings allowance rate, it is better to pay for bank service costs in direct fees, thereby freeing up account balances to invest. Treasury has maximized the investment interest by seeking an appropriation to pay for bank service costs.

- Contracting of Bank Service Costs: Treasury issues Requests for Proposals for banking services. This allows for competitive negotiation of banking services and fee schedules and the selection of a bank to provide the service at a reasonable cost. Treasury follows this best practice and then monitors the fees charged by the banks on a monthly basis to ensure contract prices are adhered to.

- Daily Concentration of Deposits: A best practice is to accelerate deposits to concentration bank accounts where the funds can be used immediately to satisfy obligations of the state or invest. Treasury uses a deposit concentration methodology to sweep funds from regional banks to concentration banks daily. This process reduces float and speeds up the use of funds. On a daily basis, Treasury determines the amount of funds in the concentration banks that are needed to satisfy obligations and invests the remainder.

- Migration to Electronic Payments: Electronic payments significantly reduce processing costs versus the cost of issuing paper checks. A best practice is to maximize the use of electronic payments in order to reduce bank fees and enhance processing efficiencies. Over the last 8 years, Treasury and other agencies responsible for disbursement processing have increased the use of electronic payments and reduced checks processed from 10.9 million to 3.3 million. As of June, 2010, 15.3 million payments were made electronically or 82.55% of all payments. (**See Exhibits B and C**)

- Strategic Use of Credit Card Receipts: Many state agencies accept credit cards as payment for obligations due the Commonwealth. Agencies must pay fees to accept credit cards, but each agency compares the cost of the fees versus the number of man hours that they save. Acceptance of credit card payments is essential for agencies that allow Internet payments. As a best practice, Treasury procures a statewide credit card processor that all state agencies and local governments can use. (**See Exhibit D**)

- Receipts of Money Due the Commonwealth: Speeding up the collection of moneys due the Commonwealth is a best practice. Receiving funds electronically through the Automated Clearing House (ACH) Network is the preferred method of receiving normal type recurring payments. For large dollar transactions, the Fed Wire System network is used to receive funds on a same-day basis. Where electronic receipts are not feasible, Treasury strongly encourages agencies to deposit checks using Remote Deposit Capture (RDC) in order to facilitate later deposit cutoffs and, in many cases, decrease float on deposited checks. In RDC, checks are scanned and transmitted to the depositing bank electronically. For agencies that receive a large volume of checks, Image Cash Letter (a high speed variation of RDC) is encouraged. For agencies that receive a large volume of checks that require special handling and reporting, customized lockboxes are established with banks. Lockboxes have been established at banks for the State Corporation Commission, Virginia Retirement System, Virginia Lottery, State Bar, Department of Health Professions and the Department of Professional and Occupational Regulation. In-house lockboxes are set up at the Department of Motor Vehicles, Department of Social Services and Department of Taxation.

Price Reductions: Based on Treasury's competitive negotiation of banking services tied to the volume of business, Treasury has achieved very competitive prices for cash management and banking services. It is believed that any further price reductions would be tied to changes in the way in which services are used. For instance, the cost of electronic payments is much less than the cost of paper checks. Therefore, further increases in electronic payments would reduce the number of checks issued and result in cost reductions as noted below in the Potential Cost Savings analysis.

Potential Cost Savings: The following are potential cost savings initiatives or recommendations:

- <u>Increase in Use of Electronic Payments:</u> Of the 18.6 million payments Treasury made in FY 2010, 15.3 million or 82.55% were made electronically. This leaves 3.2 million payments made by checks. (**See Exhibit C**). The percentage of electronic payments is broken down for payment categories as follows: VEC (99.65%); Payroll (95.94%); VRS (93.20%); Social Services (90.77%); Tax Refunds (47.48%); and General Warrants (47%). Treasury believes that some further progress can be made in switching from paper to electronic payments. However, to increase the use of electronic payments further may require an explicit mandate through an Executive Order or additional language in the Appropriation Act.

    - Almost 100% of VEC payments are made by direct deposit or through pay cards as they mandate electronic payments. The few checks written are interim payments until the recipient can be set up on the system.

    - Payroll checks include payments for garnishments, bankruptcy, child support, taxes, payday vendors and other consumer focused businesses. Only 28% of the 109,774 checks written annually are actually issued to employees (30,736 checks). The state has made great progress in processing 95.94% of payroll payments electronically. Some progress can be made on these working with agencies that have a higher percentage of check payments.

    - VRS electronic retirement payments are at 93.20%, but there are still 124,386 check payments annually. Some progress can be made on these working in conjunction with VRS and its retirees.

- Social Service electronic payments are at 90.77%, but there are still 405,921 check payments annually. Some progress can be made on these working in conjunction with Social Services and its recipients.

- Tax Refund electronic payments are at 47.48%, but there are still 1,478,940 check payments annually. Receipt of tax refunds by citizens is voluntary, dependent upon their choice of payment, whether they are electronic filers, and whether they have bank accounts. Taxation is pushing electronic filing of state returns, which in most cases result in filers asking for their funds electronically. Electronic filers are told their refunds typically take a week, while paper filers are told that it will typically take 30 days to process their return before they will receive their refund.

- General Warrant electronic payments are at 47%, and there are 1.1 million check payments annually for vendor payments and other obligations of the state. Language is provided in the Appropriations Act that permits the State Comptroller to mandate that any recipient of six or more checks annually be converted to electronic payments. There are over 21,000 vendors that fall into this category, representing over 700,000 checks that can be converted to electronic payments. The Department of Accounts is making an effort to convert these payments to electronic payments, but currently because of scarce resources is targeting only payees receiving more than 300 payments annually. In order to make further progress with general warrant electronic payments, the Department of Accounts would have to develop a timetable to increase the payments made electronically and be provided additional resources it would need to do so. As an alternative, the Department of Accounts is examining the feasibility of outsourcing appropriate components of the process needed to convert general warrant disbursements from check to electronic payments.

- Increase in Use of Electronic Receipts: Electronic collection of funds through the Automated Clearing House (ACH) is less expensive than processing checks for deposit. Further efforts to increase the collection of funds through the ACH network will reduce banking costs and decrease the float time of processing a paper check deposit.

  The cost of depositing a check can vary widely based on where the check is deposited (branch, cash vault, processing center, lockbox, etc.), how the check is prepared (encoded or not), the drawer bank, and how the deposit is prepared (cash letter or regular deposit). Volume also has a bearing with higher volume deposits receiving a lower bank fee. On average, the cost of depositing a paper check is about $.05 per check.

  The cost of processing a check electronically can vary based on whether we are using an ACH debit to draw funds from a client bank account or if the client is crediting the state using an ACH credit. Volume also has a bearing with higher volume electronic deposits receiving a lower bank fee. On average, the cost of depositing funds electronically is about $.04 per item.

Two examples of electronic collections are the Department of Taxation (Tax) and the Department of Motor Vehicles (DMV). In FY 2010, 76% of tax dollars were collected electronically, representing 43% of all transactions. In FY 2010, 71% of DMV collections were collected electronically using either ACH or credit cards, representing 40% of all transactions. Progress in electronic collections in both the DMV and Tax as well as other agencies that collect moneys can be enhanced to accelerate receipt of funds and make for a more efficient operation.

Attachments

Exhibit A

DEPARTMENT OF THE TREASURY

October 12, 2010

Bank Service Costs FY 2006 - FY 2010

Cash Management Total Spend	Concentration Banks *	Regional Banks	TOTAL
FISCAL YEAR 2010	$3,747,638	$27,541	$3,775,179
FISCAL YEAR 2009	$4,190,459	$26,741	$4,217,200
FISCAL YEAR 2008	$4,362,151	$13,564	$4,375,715
FISCAL YEAR 2007	$3,833,127	$9,236	$3,842,363
FISCAL YEAR 2006	$3,696,281	$2,863	$3,699,144

* Note: The four Concentration Banks are:

BB&T

Bank of America

SunTrust

Wachovia

DEPARTMENT OF THE TREASURY

Exhibit B

October 12, 2010

NUMBER OF CHECKS PROCESSED FYS 2003-2010

Year	General Warrant	Tax Refunds	VRS	Social Services	VEC	Payroll	Car Tax	Total Checks	Earnings Notices	Total Documents
2003	1,253,868	1,936,973	191,438	2,616,883	2,825,877	519,691	4,347	9,349,077	1,548,676	10,897,753
2004	1,254,978	1,826,763	183,061	2,559,089	2,278,910	495,351	1,457	8,599,609	1,456,857	10,056,466
2005	1,231,251	1,746,790	168,128	2,512,389	1,470,935	442,247	-	7,571,740	1,424,715	8,996,455
2006	1,139,620	1,732,244	158,546	2,422,810	1,289,055	383,245	-	7,125,520	1,458,629	8,584,149
2007	1,090,116	1,722,018	149,097	1,975,404	1,085,123	331,007	-	6,352,765	1,452,805	7,805,570
2008	1,351,526	1,676,493	145,004	893,010	61,249	291,433	-	4,418,715	1,435,659	5,854,374
2009	1,049,318	1,590,554	134,062	476,288	31,771	154,404	-	3,436,397	851,273	4,287,670
2010	1,100,203	1,478,940	124,386	405,921	18,804	109,774	-	3,238,028	53,350	3,291,378

Exhibit C

DEPARTMENT OF THE TREASURY

October 12, 2010

Electronic vs Check Payments

	ELECTRONIC PAYMENTS		CHECKS		TOTAL		% ELECTRONIC	
	FY 2010	FY 2009	FY 2010	FY 2009	FY 2010	FY 2009	FY 2010	FY 2009
Payroll	2,591,955	2,554,022	109,774	154,404	2,701,729	2,708,426	95.94%	94.30%
VRS Master	1,704,315	1,521,013	124,386	134,062	1,828,701	1,655,075	93.20%	91.90%
Tax Refund	1,336,822	1,216,282	1,478,940	1,590,554	2,815,762	2,806,836	47.48%	43.33%
Social Services	3,993,813	3,915,144	405,921	476,288	4,399,734	4,391,432	90.77%	89.15%
General Warrant	965,656	831,543	1,100,203	1,049,318	2,065,859	1,880,861	46.74%	44.21%
VA Employment Commission	5,385,896	3,435,987	18,804	31,771	5,404,700	3,467,758	99.65%	99.08%
Total EDI's July 2009 - June 2010	15,978,457	12,826,082	3,238,028	3,436,397	19,216,485	16,262,479	83.15%	78.87%

Source of Data:

Payroll, VRS, Tax Refund, DSS - From Analysis, PPD Credits

GW: Obtained from Valerie Alley; includes SPCC volume

VEC: Cindy Hartley, Asst Director of Finance at the VEC

DEPARTMENT OF THE TREASURY

October 12, 2010

Credit Card Trending

Exhibit D

	Items	Dollars	Average ticket	Expense	Effective Rate
Jan-10	1,312,633	$104,023,576	$79.25	$2,098,441	2.02%
Feb-10	1,195,546	$61,482,667	$51.43	$1,274,145	2.07%
Mar-10	1,326,847	$72,959,200	$54.99	$1,182,655	1.62%
Apr-10	1,338,776	$80,408,444	$60.06	$1,455,559	1.81%
May-10	1,409,258	$93,105,939	$66.07	$1,578,774	1.70%
Jun-10	1,355,812	$76,517,097	$56.44	$1,328,696	1.74%
Jul-10	0	$0	#DIV/0!	$0	#DIV/0!
Aug-10	0	$0	#DIV/0!	$0	#DIV/0!
Sep-10	0	$0	#DIV/0!	$0	#DIV/0!
Oct-10	0	$0	#DIV/0!	$0	#DIV/0!
Nov-10	0	$0	#DIV/0!	$0	#DIV/0!
Dec-10	0	$0	#DIV/0!	$0	#DIV/0!
2010	7,938,872	$488,496,923	$61.53	$8,918,270	1.83%

	Items	Dollars	Average ticket	Expense	Effective Rate
Jan-09	1,210,816	$132,348,813	$109.31	$2,531,005	1.91%
Feb-09	1,099,207	$58,481,670	$53.20	$1,179,266	2.02%
Mar-09	1,210,466	$68,785,744	$56.83	$1,389,908	2.02%
Apr-09	1,206,997	$72,173,524	$59.80	$1,447,542	2.01%
May-09	1,319,928	$96,530,833	$73.13	$1,903,127	1.97%
Jun-09	1,210,067	$67,948,292	$56.15	$1,374,767	2.02%
Jul-09	1,312,182	$90,846,521	$69.23	$1,816,381	2.00%
Aug-09	1,370,592	$124,630,215	$90.93	$2,455,003	1.97%
Sep-09	1,256,061	$63,432,878	$50.50	$1,327,198	2.09%
Oct-09	1,270,143	$65,682,623	$51.71	$1,379,766	2.10%
Nov-09	1,222,653	$65,338,748	$53.44	$1,380,328	2.11%
Dec-09	1,434,855	$104,422,240	$72.78	$2,087,707	2.00%
2009	15,123,967	$1,010,622,102	$66.82	$20,271,998	2.01%

	Items	Dollars	Average ticket	Expense	Effective Rate
Jan-08	1,075,756	$121,536,259	$112.98	$2,309,973	1.90%
Feb-08	965,146	$55,733,781	$57.75	$1,120,279	2.01%
Mar-08	1,056,063	$60,978,973	$57.74	$1,221,384	2.00%
Apr-08	1,047,438	$65,839,722	$62.86	$1,309,455	1.99%
May-08	1,146,094	$88,220,663	$76.98	$1,711,500	1.94%
Jun-08	1,069,012	$60,830,384	$56.90	$1,224,309	2.01%
Jul-08	1,195,602	$85,840,301	$71.80	$1,669,549	1.94%
Aug-08	1,289,555	$159,463,915	$123.66	$3,051,942	1.91%
Sep-08	1,081,342	$59,887,867	$55.38	$1,216,080	2.03%
Oct-08	1,121,483	$60,338,473	$53.80	$1,241,912	2.06%
Nov-08	1,169,378	$65,808,719	$56.28	$1,347,187	2.05%
Dec-08	1,299,092	$96,541,389	$74.31	$1,913,926	1.98%
2008	13,515,961	$981,020,446	$72.58	$19,337,496	1.97%

Ave cost per transaction	
Mar/Jun (2010)	
Expense	$5,545,684
Transactions	5,430,693
	$1.02
Jan/Apr (2009)	
Expense	$9,825,615
Transactions	7,257,481
	$1.35
Jan/Apr (2008)	
Expense	$8,896,899
Transactions	6,359,509
	$1.40
Mar/Jun '10 receipts	$322,990,680
Avg Rate '10	1.72%
Avg Rate '09/'08	1.99%
Avg Expenses '10	$5,539,290.16
Avg Expenses at 08-09 rate	$6,427,514.53
4 month savings	$888,224.37
Annualized Total Savings	$2,664,673.11